CIGARETTE TAXATION

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Prepared by

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Prepared for the Committee on Indian Affairs

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INTRODUCTION

The purpose of this report is to provide background information on the issue of cigarette taxation. The report reviews the history of cigarette excise taxes and provides an update on the status of the tax across the nation. The report also examines the imposition of the tax in Montana, with special emphasis on the problem of tax collection on Indian reservations.

BACKGROUND

An excise tax is a special sales tax targeted at specific items. The tax is generally imposed at the wholesale level and passed on to consumers in the retail sales price. Most excise taxes are levied at specific rates. The most common items subject to an excise tax are motor fuels, alcoholic beverages, and cigarette and tobacco products.

An excise tax is sometimes referred to as a sumptuary tax when it is applied to certain items, such as cigarettes and alcohol. The objectives of a sumptuary tax are to discourage the consumption of certain products and to charge the user for any social costs that might be borne by the public at large.[1] For the smoker, some of the social costs of cigarette use are an increased incidence of heart disease, emphysema, and lung cancer. For the nonsmoker, the social costs include increased medical costs and higher taxes for Medicaid, Medicare, and other health care programs. Sumptuary taxes are often called "sin taxes".

Cigarette taxes have historically been a stable source of revenue for state governments. This stability was due to the inelasticity of demand and historic increases in consumption. This steadily increasing consumption coupled with periodic tax increases contributed to a steady growth in cigarette tax revenue.

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[1] Thomas F. Pogue, "Excise Taxes," Steven D. Gold (ed.), Reforming State Tax Systems (Denver: National Conference of State Legislatures, 1986), p. 262.

However, in recent years, the revenue growth has been due solely to tax increases because of the decline in the consumption of tobacco products. In 1976, the annual U.S. per capita consumption of cigarettes was 2,900; in 1987, it was 2,400.[2] With increasing recognition of the hazards associated with cigarette smoking, this trend toward decreased consumption is most likely to continue. Unless further tax increases are imposed, revenue will decline.

Revenue will also decline because of the manner in which cigarettes are taxed. The per unit system does not allow for inflationary growth in the taxes. Over time, inflation erodes revenue if there are no tax increases, thus diminishing the importance of cigarette taxes in relation to other taxes. One way to curb declining revenue is by changing the per unit tax to an ad valorem tax or by indexing for inflation. Currently, only Hawaii employs an ad valorem tax on cigarettes--40% of the wholesale price, and no state has an indexed cigarette tax rate.[3]

HISTORY

Excise taxes are among the oldest taxes in the world. Governments in China and Europe have levied excise taxes for hundreds of years.[4] The first excise taxes in the United States were levied after ratification of the Constitution.[5] The Whiskey Rebellion of 1794 was a reaction to the imposition of an excise tax on liquor. These taxes were abolished by Thomas Jefferson but revived temporarily during the War of 1812. Excise taxes at the national level did not appear again until after the Civil War. The first tax on cigarettes was imposed in 1864 at the

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[2] Katherine W. McElveen, "Texas Alcohol and Tobacco Taxes," Rethinking Texas Taxes (Austin, Texas: Select Committee on Tax Equity, 1989), Vol. 2, p. 413.

[3] Pogue, p. 272.

[4] McElveen, p. 405.

[5] Joseph A. Pechman, Federal Tax Policy (Washington, D.C.: Brookings Institution, 1987), p. 307.

rate of 8/10 of $.01 per pack of 20 cigarettes.[6]

The excise tax system imposed after the Civil War essentially remained in place until 1965.[7] Alcohol and tobacco taxes became permanent parts of the federal revenue system, supplemented by numerous other taxes. The list of excise taxes was expanded after World War I.

The first state to impose a cigarette tax was Iowa in 1921.[8] The tax was $.02 per pack of 20 cigarettes. Many states adopted a cigarette tax in response to the fiscal problems brought about by the Great Depression.[9] By the end of 1939, 21 states had adopted a cigarette tax.[10] Currently, all 50

states impose a tax on cigarette sales, with North Carolina being the last state to adopt a cigarette tax in 1969. [11]

After the Korean War, the federal government began the gradual dismantling of its excise tax structure. By 1965, only a few major excise taxes, levied for sumptuary and regulatory reasons and as user charges, remained. Among those was the cigarette excise tax. The current federal tax is $.16 per pack of 20 cigarettes.

CURRENT STATUS

Currently, every state imposes a cigarette tax. The tax is usually in addition to any license tax imposed on wholesalers and retailers. The tax generally depends on the weight, dimensions, and manner in which the cigarettes are packed. The tax is usually in the form of a stamp tax, with the intention that each pack be taxed only once.

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[6] Report Relative to Cigarette Bootlegging (Boston: Legislative Research Council, 1980), p. 8.

[7] Pechman, pp. 305-306.

[8] Report Relative to Cigarette Bootlegging, loc. cit.

[9] McElveen, p. 407.

[10] Ibid.

[11] Report Relative to Cigarette Bootlegging, loc. cit.

There is considerable variance in the tax rates. The lowest is $.025 per pack in Virginia; the highest is $.43 per pack in Minnesota.[12] Every state has increased its tax rate since the tax was first initiated. Nontobacco-producing states have increased rates to provide additional revenue and discourage consumption; tobacco-producing states have generally maintained low rates.[13] The resulting disparities have made cigarette tax evasion, or "bootlegging", a major regulatory problem for every state.

There are four categories of cigarette tax evasion.[14] The first category is casual smuggling whereby individuals from a high tax state travel to a low tax state to purchase cigarettes for personal use or for friends. The second category is organized smuggling whereby large quantities of cigarettes are routinely transported between states for illegal sale. The mail-order purchase of cigarettes from low tax states is the third category. The last category is the purchase of cigarettes from tax-free outlets, such as international ports of entry, military post exchanges, and Indian reservations.

Although casual smuggling of cigarettes is probably the most prevalent form of cigarette tax evasion, it does not generate as much concern as other forms (except among tax administrators and some law enforcement officials). Smuggling through mail-order purchase of cigarettes has been virtually eliminated in recent years because of increased enforcement of the federal mail fraud statutes. Organized smuggling declined in the 1980s with the passage and enforcement of the Federal Cigarette Contraband Act of 1978, although budget cuts in the Bureau of Alcohol, Tobacco, and Firearms have hampered efforts to curtail smuggling in recent years.[15]

The fourth category of tax evasion is the one that is of most concern in the western United States--the purchase of cigarettes through tax-free outlets,

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[12] State Tax Guide (Chicago: Commerce Clearing House, Inc., 1991), p. 5515.

[13] Report Relative to Cigarette Bootlegging, loc. cit.

[14] Issues in Cigarette Taxation (Tallahassee: Florida Advisory Council on Intergovernmental Relations, 1979), p. 11.

[15] Kenneth E. Warner, "Cigarette Excise Taxation and Interstate Smuggling: An Assessment of Recent Activity," National Tax Journal, Vol. XXXV, No. 4, December 1982, p. 487.

namely Indian reservations. It has been estimated that the state of Washington loses approximately $8.9 million per year through the sale of untaxed cigarettes to non-Indians on Indian land.[16] In Montana, that loss is about $1.3 million per year.[17] This issue has been litigated in some states, while in others cooperative agreements have been negotiated between the state government and Indian tribes. In Montana, the issue has yet to be resolved.

MONTANA

Montana enacted a cigarette excise tax in 1947 (Chapter 289, Laws of 1947). The tax rate was $.02 per pack of 20 cigarettes, and the revenue was deposited into the general fund. In 1951, Initiative No. 54 was passed by the Montana electorate and imposed an additional tax of $.02 per pack for the payment of an honorarium to each resident of the state who was on active military duty during World War II. This honorarium was later extended to World War I (Chapter 270, Laws of 1963) and Korean War veterans and was funded by an additional tax of $.01 per pack (Chapter 44, Laws of 1957). The Legislature created a long-range building program in 1967 and funded it with a portion of the $.03 honorarium tax (Chapter 318, Laws of 1967). In 1981, the honorarium bonds were retired and the separate tax was eliminated (Chapter 267, Laws of 1981). As in most states, Montana steadily increased its cigarette tax over the years. The current tax rate is $.18 per pack. The revenue goes to the long-range building program for debt service and capital projects, with any surplus accruing to the general fund.

Montana's revenue from the cigarette tax steadily increased from its inception until the mid-1980s. However, beginning in fiscal year 1985, revenue began to decline.[18] There was a slight increase (4%) in revenue from 1989 to 1990,[19] but this increase coincided with a 12.5% tax rate increase from $.16 to $.18 per pack (Chapter 681, Laws of 1989).

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[16] State of Washington Legislative Budget Committee, "Cigarette Tax Study," Report No. 90-2, April 27, 1990, p. 3.

[17] Minutes of the House Taxation Committee, April 3, 1991, p. 3.

[18] Montana Department of Revenue Biennial Report 1986-1988, Montana Department of Revenue, p. 40.

[19] Biennial Report of the Montana Department of Revenue 1988-1990, p. 48.

Revenue from the cigarette tax accounts for approximately 2% of Montana's total tax revenue.[20]

The major source of cigarette tax evasion in Montana is the sale of nontaxed cigarettes to non-Indians on reservations. Only tribal members are entitled to purchase tax-free cigarettes on a reservation, but because the state has never asserted its authority to collect the tax on the reservation, non-Indian purchasers benefit from the reservation's tax-exempt status. Twenty-nine percent of Montana's cigarette sales in 1990 were made on reservations.[21] The smokeshops on reservations openly advertise reservation discount prices.[22] In testimony offered in opposition to legislation to collect the cigarette tax from non-Indians on a reservation, the manager of a smokeshop on a reservation stated that "over half of the cigarettes we sell are to out-of-state tourist traffic".[23]

Collection of the cigarette tax on the reservations was not a major issue until the mid-1970s. In 1975, law enforcement officials arrested a tribal member on the Flathead Reservation for failure to possess a cigarette retailer's license and for selling nontax-stamped cigarettes. This action ultimately led to a United States Supreme Court decision that held that the state was barred from imposing the cigarette tax on on-reservation sales to tribal members and from requiring a vendor license fee from a tribal member operating a smokeshop on a reservation. However, the state could require an Indian smokeshop operator to add the state tax to the sales price when selling to non-Indians. Moe v. Confederated Salish and Kootenai Tribes of the Flathead Reservation, 425 US 463 (1976). In 1979, Montana passed legislation to permit the sale of cigarettes without a license by persons exempt from state cigarette taxation provisions (Chapter 382, Laws of 1979). In that same year, only 4% of the state cigarette sales occurred on reservations.[24]

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[20] Ibid., p. 5.

[21] Minutes of the House Taxation Committee, April 3, 1991, p. 3.

[22] Advertisement in Escort Magazine, 1990-1991, p. 13.

[23] Testimony of Ken Krantz, Exhibit No. 8, Minutes of the Senate Taxation Committee, March 3, 1989.

[24] Minutes of the House Taxation Committee, April 3, 1991, p. 3.

The Montana Legislature has attempted at least twice to pass legislation that would require non-Indian purchasers of cigarettes on a reservation to pay the state cigarette tax. Senate Bill No. 440 was introduced in 1989; House Bill No. 1012 was introduced in 1991. The bills were very similar in content. Under the bills' provisions, all cigarettes sold by an Indian retailer to tribal members within the boundaries of the tribe's reservation were specifically exempt from the state tax. However, a wholesaler would be required to precollect the tax on all cigarettes entering the reservation for retail sale. The wholesaler could then seek a refund or tax credit for the precollected taxes on cigarettes sold by an Indian retailer to tribal members on a reservation. The refund or tax credit would be equal to the tax due on the average individual consumption of cigarettes, determined by Department of Revenue rule, multiplied by the tribal member population of the reservation on which the sales were made. Before a refund or tax credit would be allowed, the wholesaler would have to prove that the economic benefit of the refund or credit had been passed on to the Indian retailer. House Bill No. 1012 also required the Department of Revenue to:

(1) negotiate with the individual tribes on the methods of implementing the legislation;

(2) discuss and negotiate alternative methods for collection of the cigarette tax, including the possibility of future tribal taxation;

(3) discuss and negotiate with the individual tribes the possibility of resolving other state taxation issues through state-tribal cooperative agreements; and

(4) report its findings to the Committee on Indian Affairs prior to the convening of the 53rd Legislature.

The proponents of Senate Bill No. 440 and House Bill No. 1012 argued that passage of the legislation would result in significant revenue to the state. The unfair competitive advantage that tribal retailers have over nontribal retailers would be eliminated. The cigarette tax would be fairly and uniformly levied, severely curtailing tax evasion by those required to pay. It would also cut down on the amount of cigarettes being smuggled into neighboring states from the reservations.

Opponents argued that the refund system was too elaborate and complex to be simply administered. They further argued that the legislation was ambiguous and uncertain, resulting in a lot of unanswered questions. Wholesalers and trucking interests stated that passage of the legislation would result in Indian retailers purchasing cigarettes from out-of-state wholesalers, forcing in-state wholesalers and truckers to lay off employees and to suffer economic distress. Indian

retailers argued that the legislation would result in a loss of jobs and loss of tourism on already economically depressed reservations. Opponents also argued that the tax revenue anticipated by the legislation would not materialize because the largest number of sales on the reservations is made to tourists, and these sales would not occur if the tax were imposed. Any new revenue would be more than offset by the economic losses suffered by wholesalers, truckers, and Indian retailers.

Senate Bill No. 440 died in the Senate Taxation Committee. House Bill No. 1012 was eventually passed by the Legislature and signed by the Governor but not before it was amended to remove the tax collection scheme and retain the language relating to state-tribal negotiations.

CONCLUSION

The cigarette excise tax has long been a relatively stable source of revenue for state governments. However, as more people quit smoking and fewer people begin, cigarette tax revenue will likely decline in the absence of increases in tax rates or changes in the way cigarette taxes are levied.

In Montana, a potential source of additional revenue is the collection of the tax on cigarettes sold on a reservation to non-Indian purchasers. The state has the right to collect the tax, but the method of doing so is the issue to be resolved. A future report will analyze the methods used by different states to address this issue.

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